WRITTEN STATEMENT OF
THE U.S. SECURITIES AND EXCHANGE COMMISSION

CONCERNING REGULATION FD ("FAIR DISCLOSURE")

BEFORE THE
SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE AND GOVERNMENT SPONSORED ENTERPRISES

COMMITTEE ON FINANCIAL SERVICES
UNITED STATES HOUSE OF REPRESENTATIVES

MAY 17, 2001

Chairman Baker, Congressman Kanjorski and Members of the Committee:

The Securities and Exchange Commission ("SEC" or "Commission") is pleased to submit this statement concerning Regulation FD, which is sometimes referred to as Regulation Fair Disclosure. The Commission adopted Regulation FD last year to address the problem of "selective disclosure" of material information by issuers of securities. Selective disclosure and Regulation FD have been matters of great interest and importance to investors in our securities markets, securities issuers, and market professionals. We appreciate the Committee's interest in this area.

This statement provides a brief overview of the background to Regulation FD and the rulemaking process undertaken by the Commission, a summary of the key provisions of the Regulation, and a discussion of the Commission's experience in the first months under the new Regulation. The Acting Chairman and each of the Commissioners will also be making a separate statement to the Committee regarding Regulation FD.

BACKGROUND OF REGULATION FD

1. "Selective Disclosure" and Insider Trading Law

Regulation FD grew out of the Commission's concern about the practice of "selective disclosure." The term "selective disclosure" refers to a practice by which issuers of securities selectively provide material, nonpublic information to certain persons – often, securities analysts or institutional investors – before disclosing this same information to the public.

Selective disclosure raises several concerns. The primary issue is the basic unfairness of providing a select few with a significant informational advantage over the rest of the market. This unfairness damages investor confidence in the integrity of our capital markets. To the extent some investors decide not to participate in our markets as a result, the markets lose a measure of liquidity and efficiency, and the costs of raising equity capital are increased. Further, if selective disclosure is permitted, corporate management can treat material information as a commodity to be used to gain or maintain favor with particular analysts or investors. This practice could undermine analyst objectivity, in that analysts will feel pressured to report favorably about a company or slant their analysis to maintain access to selectively disclosed information. Thus, selective disclosure may tend to reduce serious, independent analysis.

Prior to Regulation FD, the legal question presented by selective disclosure was whether this practice violated insider trading law and was thus subject to civil and criminal penalties as a type of securities fraud. Under judicial interpretations regarding insider trading law, the answer has not always been clear. Early insider trading case law appeared to require that traders have equal access to corporate information, and indicated that selective disclosure of material information to securities analysts could lead to insider trading liability.[1] This changed, however, with the Supreme Court's decisions in *Chiarella v. United States*[2] and *Dirks v. SEC*.[3] In the *Dirks* case, in particular, which concerned the disclosure of material nonpublic information by a company insider to an analyst, the Court's decision indicated that insider trading liability would arise only when the insider received a "personal benefit" from giving the information to the analyst. After *Dirks*, there have been very few insider trading cases based on disclosures of material nonpublic information to, or trading by, securities analysts.[4]

Against this backdrop of legal uncertainty, the Commission began to see increasing numbers of public reports that issuers were disclosing important nonpublic information, such as advance warnings of earnings results, to selected securities analysts or institutional investors before public disclosure.[5] Even after Commissioners began to focus public attention on this practice through speeches,[6] reports of additional selective disclosures continued. The issue for the Commission then became what, if any,

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1 *SEC v. Texas Gulf Sulphur Co*., 401 F.2d 833, 849 (2d Cir. 1968)(en banc), *cert. denied*, 394 U.S. 976 (1969); *SEC v. Bausch & Lomb, Inc*., 565 F.2d 8 (2d Cir. 1977).

2 445 U.S. 646 (1980).

3 463 U.S. 646 (1983).

4 The rare case involving a disclosure to securities analysts is *SEC v. Phillip J. Stevens*, Litigation Release No. 12813 (Mar. 19, 1991), a settled matter where the Commission alleged that a corporate official's "personal benefit" from the disclosure arose from a desire to protect and enhance his reputation.

5 A number of reported examples of this practice are cited in the Commission's rulemaking releases. *See* Proposing Release, 64 FR 72590, 72591 & fn. 11 (Dec. 28, 1999); Adopting Release, 65 FR 51716, 51717 & fn. 11 (Aug. 24, 2000).

6 *See, e.g.*, Remarks of Chairman Arthur Levitt to the "SEC Speaks" Conference, "A Question of Integrity: Promoting Investor Confidence By Fighting Insider Trading" (Feb. 27, 1998); Remarks of Commissioner Isaac C. Hunt, Jr., "Navigating the Sea of Communications" (Feb. 26, 1999); Remarks of Commissioner Laura S. Unger, "Corporate Communications Without Violations: How Much Should Issuers Tell Their Analysts and When" (Apr. 23, 1999). Copies of these speeches are available on the SEC's website at www.sec.gov.

regulatory response was appropriate. One option would have been to pursue a series of "test cases" charging fraudulent insider trading in some of these matters, with the goal of clarifying existing judicial interpretations in this area. Ultimately, however, rather than engage in what some might call "regulation by enforcement," the Commission determined that the better approach was to engage in rulemaking proceedings, with full opportunity for public notice and comment, in order to craft a more targeted regulatory response to selective disclosure.

2. The Commission's Public Rulemaking for Regulation FD

The Commission proposed new Regulation FD at an open meeting held on December 15, 1999.[7] This proposal did not treat selective disclosure as a form of insider trading, but instead proposed a new, non-fraud based, issuer disclosure rule aimed at the practice. Proposed Regulation FD was highly publicized and generated great public interest. In addition, Commission staff conducted outreach efforts to ensure that affected members of the regulated community were aware of the proposal and to encourage participation in the public rulemaking process.[8] The Commission received more than 6,000 comment letters on the proposal, most of which were posted on the Commission's website as they were received, where they remain available for public review.

The vast majority of commenters were individual investors who urged the Commission to adopt Regulation FD. Individual investors expressed strong support for

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[7] The Proposing Release was published in the Federal Register on December 28, 1999. Selective Disclosure and Insider Trading, 64 FR 72590 (Dec. 28, 1999). (In addition to Regulation FD, the proposal also contained proposed rules 10b5-1 and 10b5-2, which dealt with discrete issues under insider trading law.) The Commission originally provided for a 90-day public comment period, which was later extended for an additional 30 days. 65 FR 16160 (March 27, 2000).

[8] For example, shortly after the proposal the Commission's former General Counsel participated in a conference call sponsored by the National Investor Relations Institute to discuss and answer questions

the regulation. Many noted that selective disclosure is indistinguishable from insider trading in its effect on the market and their perception of the market's fairness. Others reported that today's self-directed, online investors conduct their own research and analysis and do not expect to rely exclusively on analysts' research and recommendations. With advances in information technology, these investors noted, information can be communicated to investors directly and in real time, without the need for intermediaries.

In addition to the thousands of investor comments, the Commission received many comments from a range of other interested parties: securities industry participants, issuers, attorneys, media representatives, and professional and trade associations. Almost all of these commenters agreed that selective disclosure of material nonpublic information was inappropriate and supported the Commission's goals of promoting broader and fairer issuer disclosure. While some of these commenters believed the proposed regulation was generally appropriate as a means of addressing selective disclosure, many others expressed concerns about the approach and suggested alternate methods of achieving the goals or recommended various changes to the proposed regulation. One frequently expressed concern was that rather than resulting in broader dissemination of information, Regulation FD might "chill" issuer disclosure practices. In order to avoid this effect, some commenters stated that the Commission should not adopt an enforceable rule against selective disclosure, but instead should encourage issuers to voluntarily engage in "best practices" with regard to disclosure. Other commenters

about proposed Regulation FD. During the comment period, the Commission staff held numerous meetings with interested parties, including industry and bar association representatives.

recommended various ways that the Commission could narrow Regulation FD's scope to address this and other concerns.

In response to the comments received on the proposal, the Commission made several significant changes to the final rules, to narrow its scope and further guard against any chilling effect.

- First, the Commission narrowed the scope of the regulation to apply to a relatively limited category of issuer communications. The effect of these changes is that Regulation FD does not apply to ordinary-course business communications or disclosures to the media.
- Second, the Commission added a provision to Regulation FD to make it absolutely clear that private plaintiffs cannot rely on an issuer's Regulation FD violation as a basis for a private action alleging fraud.
- Third, the Commission made changes to the regulation to give issuers greater assurance that they would not be second-guessed by the SEC in enforcement actions for mistaken judgments about materiality in close cases.
- Fourth, the Commission made several changes to address concerns about the interplay between Regulation FD and the Securities Act of 1933 ("Securities Act") -- most notably, expressly excluding from the scope of Regulation FD communications made in connection with most securities offerings registered under the Securities Act. These changes significantly reduced the reach of the regulation.

With these changes, the Commission adopted Regulation FD at an open meeting held on August 10, 2000.[9]

SUMMARY OF REGULATION FD

The final rule adopted by the Commission is fairly straightforward. Under Regulation FD, whenever:

(1) an issuer, or person acting on its behalf;

(2) discloses material nonpublic information;

(3) to certain enumerated persons (in general, securities market professionals or holders of the issuer's securities whom one has reason to believe will trade on the basis of the information);

(4) the issuer must make public disclosure of that same information:

a. simultaneously (for intentional disclosures), or

b. promptly (for non-intentional disclosures).

As a whole, the regulation requires that when an issuer makes an intentional disclosure of material nonpublic information to a person covered by the regulation, it must do so in a way that provides general public disclosure, rather than through a selective disclosure. If an issuer makes a non-intentional selective disclosure, the issuer must publicly disclose the information promptly after it knows (or is reckless in not knowing) that the information selectively disclosed was <u>both</u> material and nonpublic.

A more detailed explanation of some of the regulation's key requirements is provided below.

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[9] Former Chairman Levitt, Commissioner Hunt, and Commissioner Carey voted to adopt the regulation; then-Commissioner, now Acting Chairman, Unger dissented. Acting Chairman Unger's dissent was based on her belief that Regulation FD was an overly broad solution to the acknowledged problem of selective disclosure.

1. Whose disclosures are covered?

Regulation FD applies to most issuers of publicly-traded securities. Specifically, it covers all issuers with securities registered under Section 12 of the Securities Exchange Act ("Exchange Act") and all issuers required to file reports under Section 15(d) of the Exchange Act, including closed-end investment companies, but not including other investment companies, foreign governments, or foreign private issuers.[10]

The regulation applies to disclosures made by a "person acting on behalf of an issuer." That term is defined as (1) any senior official of the issuer[11] or (2) any other officer, employee, or agent of an issuer who regularly communicates with certain types of securities market professionals or with the issuer's security holders.[12] Thus, the regulation covers senior management, investor relations professionals, and others who regularly interact with securities market professionals or security holders. An issuer can designate particular officials as its authorized spokespersons for purposes of the regulation.

2. Disclosures to whom are covered?

Regulation FD's general rule against selective disclosure applies only to disclosures made to four categories of persons.[13] The first three are securities market professionals – (1) broker-dealers and their associated persons, (2) investment advisers, certain institutional investment managers, and their associated persons, and (3) investment companies, hedge funds, and affiliated persons. These categories include sell-

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[10] 17 CFR 243.101(b).

[11] "Senior official" is defined as any director, executive officer, investor relations or public relations officer, or other person with similar functions. 17 CFR 243.101(f).

[12] 17 CFR 243.101(c).

side analysts, many buy-side analysts, large institutional investment managers, and other market professionals who may be likely to trade on the basis of selectively disclosed information. The fourth category of persons covered is any holder of the issuer's securities, under circumstances in which it is reasonably foreseeable that such person would trade securities on the basis of the information. Thus, Regulation FD is designed to cover the types of persons most likely to receive and trade on improper selective disclosure, but not persons engaged in ordinary-course business communications with the issuer. Similarly, Regulation FD does not cover disclosures to the media or communications to government agencies.

There are four specific exclusions from coverage provided in the regulation: (1) communications to a person who owes the issuer a duty of trust or confidence, such as an attorney, investment banker, or accountant, (2) communications to any person who expressly agrees to maintain the information in confidence, (3) disclosures to credit ratings agencies, provided the information is disclosed solely for the purpose of developing a credit rating and the entity's ratings are publicly available, and (4) communications made in connection with most offerings of securities registered under the Securities Act.[14]

3. "Material nonpublic information"

Regulation FD applies to disclosures of "material nonpublic information" about the issuer or its securities.[15] The regulation relies on existing definitions of "material" and "nonpublic" established in the case law. Information is "material" if "there is a

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13 17 CFR 243.100(b)(1).

14 17 CFR 243.100(b)(2).

15 17 CFR 243.100(a).

substantial likelihood that a reasonable shareholder would consider it important" in making an investment decision.[16] To be material there must be a substantial likelihood that a fact "would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available."[17] Information is nonpublic if it has not been disseminated in a manner making it available to investors generally.[18]

In response to a number of comments suggesting more interpretive guidance about types of information or events that are more likely to be considered material, the Commission included in the Adopting Release a list of the following items as some types of information or events that should be reviewed carefully to determine whether they are material: (1) earnings information; (2) mergers, acquisitions, tender offers, joint ventures, or changes in assets; (3) new products or discoveries, or developments regarding customers or suppliers; (4) changes in control or in management; (5) change in auditors or auditor notification that the issuer may no longer rely on an auditor's audit report; (6) events regarding the issuer's securities; and (7) bankruptcies or receiverships.[19]

One area of concern was the practice of issuers providing "guidance" to securities analysts regarding earnings forecasts. The Adopting Release stated that an issuer official

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16 *TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976); *see Basic v. Levinson*, 485 U.S. 224, 231 (1988).

17 *Id.*

18 *See, e.g., SEC v. Texas Gulf Sulphur*, 401 F.2d 833, 854 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969); *In re Investors Management Co.*, 44 S.E.C. 633, 643 (1971).

19 65 FR at 51721.

who engages in a private discussion with an analyst seeking guidance about earnings estimates takes on a high degree of risk under Regulation FD.

At the same time, although Regulation FD prohibits selective disclosure of *material* nonpublic information, an issuer may still disclose *non-material* information to an analyst even if that information helps the analyst complete a "mosaic" of information that, taken as a whole, is material. The focus of Regulation FD is material nonpublic information, not information that an analyst, through some combination of persistence, knowledge and insight, regards as material, even though its significance would not be apparent to the reasonable investor.

Further, the Commission made clear that the "simultaneous" disclosure requirement in the regulation applies only when issuers know or are reckless in not knowing that the information disclosed was material. This provides additional assurance that issuers need not fear being second-guessed by the Commission in enforcement actions for mistaken judgments about materiality in close cases.

4. Timing of required public disclosure under Regulation FD

Under Regulation FD, the timing of required public disclosure differs depending on whether the issuer has made an "intentional" or "non-intentional" selective disclosure. For an intentional selective disclosure, the issuer is required to publicly disclose the same information simultaneously.[20] Regulation FD states that a selective disclosure is "intentional" when the issuer or person acting on behalf of the issuer either knows, or is

[20] 17 CFR 243.100(a)(1).

reckless in not knowing, at the time of disclosure, that the information he or she is communicating is both material and nonpublic.[21]

When an issuer makes a selective disclosure that is "non-intentional," it is required to make public disclosure promptly.[22] "Promptly" means as soon as reasonably practicable but not after the later of 24 hours or the start of the next day's trading on the New York Stock Exchange, after a senior official learns of the disclosure and knows (or is reckless in not knowing) that the information disclosed was both material and nonpublic.[23]

5. How to make the required public disclosure

Regulation FD gives issuers flexibility in determining how to make the required public disclosure. Issuers can make "public disclosure" of material information by including it in a Form 8-K filed or furnished with the Commission.[24] Alternatively, issuers can make public disclosure "through another method (or combination of methods) of disclosure that is reasonably designed to provide broad, non-exclusionary distribution of the information to the public."[25]

This alternative standard does not require use of any particular method or establish a "one size fits all" disclosure standard for issuers. Instead, issuers are able to choose the method or combination of methods best suited to their own circumstances as long as the method (or combination of methods) is reasonably designed to effect broad

[21] 17 CFR 243.101(a).

[22] 17 CFR 243.100(a)(2).

[23] 17 CFR 243.101(d).

[24] 17 CFR 243.101(e)(1).

[25] 17 CFR 243.101(e)(2).

public disclosure. The Adopting Release states that generally acceptable methods of public disclosure include press releases distributed through a widely circulated news or wire service, or announcements made through press conferences or open conference calls that the public may attend or listen to either in person, by telephone, or by other electronic transmission (including the Internet). An issuer must give the public adequate notice of the conference or call and the means for accessing it.

The Adopting Release sets forth the following "best practices" model, which employs a combination of disclosure methods for making a planned disclosure of material information, such as a scheduled quarterly earnings release: (1) issue a press release containing the information; (2) provide adequate notice, via a press release and/or a website posting, of a conference call to discuss the announced results, providing the date and time of the call and instructions for accessing it; (3) hold the conference call in an open manner, allowing investors to listen on the phone or through a webcast.

6. Liability for violations of Regulation FD

The Commission recognized that the prospect of private liability under Regulation FD could contribute to a "chilling effect" on issuer communications. Accordingly, the regulation expressly provides that a failure to make a disclosure required solely by Regulation FD will not violate the general antifraud rule, Rule 10b-5.[26] Thus, private plaintiffs cannot rely on a Regulation FD violation as a basis for a private securities fraud lawsuit. The regulation is enforceable only by the Commission.

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[26] 17 CFR 243.102.

REGULATION FD: EXPERIENCES OF THE FIRST SEVERAL MONTHS

As noted, the Commission adopted Regulation FD on August 10, 2000. The regulation became effective on October 23, 2001, and has been in effect for just over six months.

In the short time since the regulation was adopted, the Commission's staff has provided oral and written interpretive guidance regarding Regulation FD. The Division of Corporation Finance's Office of Chief Counsel has answered numerous telephone requests for interpretive advice on the regulation. Even before the rule became effective, the Division published written "Qs&As" responding to certain questions raised by issuers or their counsel, and it has since supplemented this staff interpretive guidance. Moreover, Commission senior staff have given speeches and participated in numerous legal and industry forums to discuss Regulation FD. These continuing efforts to meet requests for guidance have been designed to smooth the transition in the behavior and expectations of issuers, analysts, institutional investors and the investing public.

The Commission has not brought any enforcement cases thus far based on violations of Regulation FD. In light of concerns expressed by some about the threat of possible unwarranted enforcement actions, the Commission's Director of Enforcement has publicly stated that Regulation FD was not designed as a "trap for the unwary" and that enforcement cases will not be based on second-guessing reasonable judgments made in good faith by issuers, including judgments about materiality.[27] These remarks, and

[27] Richard H. Walker, "Regulation FD – An Enforcement Perspective," Remarks to the Compliance and Legal Division of the Securities Industry Association (Nov. 1, 2000).

similar ones by other Commission officials, have indicated that Commission enforcement of the regulation will be focused on clear violations.

Because of the significance of Regulation FD, the Commission has been committed to carefully evaluating its operation and effects. At the open meeting during which the regulation was adopted, the Commission asked the SEC's Office of Economic Analysis to conduct a study of Regulation FD's effect after sufficient time had passed to gather the appropriate data. That Office has begun to examine several questions regarding the possible effects of Regulation FD, although in consultation with leading academics it has concluded that significantly more data than is currently available will be necessary to complete its task. In addition, it has been noted by various commentators that the precipitous change in current market conditions and other structural changes in markets will require a longer window of experience with Regulation FD to effectively measure its impact.

The Commission and staff have also closely monitored the results of preliminary surveys and reports generated by others concerning the operation and effects of Regulation FD. These surveys, however, have reflected perceptions of behaviors only over the initial transition period under the regulation, during which issuers and market participants have been adjusting to its requirements.

Since Regulation FD became effective, the Commission has reaffirmed its commitment to monitor its effects. On April 24, Acting Chairman Unger moderated a roundtable discussion in New York City among industry participants, issuers, media, investor groups, academics, and attorneys to discuss experiences to date with Regulation

FD. The discussion was open to the public and simultaneously webcast for the benefit of those who were interested but unable to attend in person.[28]

Roundtable panelists commented on several important issues, including the flow of information from issuers, the role of analysts in the marketplace, and market volatility. Given the diverse backgrounds and experiences of the participants, the discussion was robust and the participants often disagreed. Representatives of issuers differed on the extent to which Regulation FD has altered their disclosure practices. Participants representing disseminators of information, including wire services, generally agreed that issuers are making more public disclosure since Regulation FD took effect. Securities analysts generally felt that Regulation FD had negatively affected their ability to obtain quality information from issuers. One relatively common point of agreement, however, was that it was still very early to assess the impact of Regulation FD, given the limited period of time in which the regulation had been in effect and the variety of other unusual conditions that have affected the markets during this period. There was also a sense among many roundtable participants that more guidance or "best practices" regarding compliance with the regulation might be helpful for the future.

Acting Chairman Unger is preparing a report that will provide more detailed observations about the roundtable discussion.

CONCLUSION

The Commission adopted Regulation FD after rulemaking proceedings in which it heard comments from all points of view. Both critics and supporters of the regulation have continued to debate its merits and effects from the moment of its adoption to the

[28] The webcast is archived and remains accessible on the Commission's website at www.sec.gov.

present. While the Commission has followed this continuing debate with interest, it is still very early to measure in any objective manner the effects of Regulation FD. Given the importance of Regulation FD, the Commission remains committed to a careful examination of the effects of the regulation as we gain greater experience under it, and to consideration of the need for additional interpretive guidance as appropriate.